

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF LAKEWOOD VALLEY SEWER)	
CO., INC. FOR A RATE ADJUSTMENT PURSUANT)	CASE NO.
TO THE ALTERNATIVE RATE FILING PROCEDURE)	93-279
FOR SMALL UTILITIES)	

O R D E R

On August 11, 1993, Lakewood Valley Sewer Co., Inc. ("Lakewood") filed its application for Commission approval to increase its sewer rates. Commission Staff, having performed a limited financial review of Lakewood's operations, has prepared the attached Staff Report containing Staff's findings and recommendations regarding the proposed rates. All parties should review the report carefully and provide any written comments or requests for a hearing or informal conference no later than 15 days from the date of this Order.

IT IS THEREFORE ORDERED that all parties shall have no more than 15 days from the date of this Order to provide written comments regarding the attached Staff Report or requests for a hearing or informal conference. If no request for a hearing or informal conference is received, then this case will be submitted to the Commission for a decision.

Done at Frankfort, Kentucky, this 12th day of November, 1993.

PUBLIC SERVICE COMMISSION


For the Commission

ATTEST:


Executive Director

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF LAKEWOOD)	
VALLEY SEWER CO., INC. FOR A)	
RATE ADJUSTMENT PURSUANT TO)	CASE NO. 93-279
THE ALTERNATIVE RATE FILING)	
PROCEDURE FOR SMALL UTILITIES)	

STAFF REPORT

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STAFF REPORT

ON

Lakewood Valley Sewer Co., Inc.

CASE NO. 93-279

A. Preface

On August 11, 1993, the Lakewood Valley Sewer Co., Inc. ("Lakewood") filed its application seeking to increase its rates pursuant to the Alternative Rate Filing Procedure for Small Utilities. Lakewood's proposed rates would produce an increase in its annual revenues of 74.26 percent over test period normalized revenues from rates of \$40,226.

In Order to evaluate the requested increase, the Commission Staff ("Staff") chose to perform a limited financial review of Lakewood's operations for the test period, the calendar year ending December 31, 1992. Mark Frost of the Commission's Division of Financial Analysis performed the limited review on September 29, 1993 and October 4, 1993.

Mr. Frost is responsible for the preparation of this Staff Report except for Section B, Operating Revenue; Section D, Rate Design; and Appendix A, which were prepared by Sam Reid of the Commission's Division of Rates and Research. Based on the findings contained in this report, Staff recommends that Lakewood be allowed to increase its revenues from rates by \$17,969.

Scope

The scope of the review was limited to obtaining information as to whether the test period operating revenues and expenses were

representative of normal operations. Insignificant or immaterial discrepancies were not pursued and are not addressed herein.

B. Analysis of Operating Revenues and Expenses

Operating Revenues

Lakewood reported a total of 225 customers and revenue from rates of \$40,689 in their 1992 annual report. According to the application, there are presently 222 residential customers. The revenue these customers will produce is \$40,226. Accordingly Staff's adjustment in revenue from rates is a decrease in the amount of \$463. Therefore, for the purpose of this report, total test period normalized operating revenue shall be considered to be \$40,226.

Operating Expenses

In its application Lakewood reported actual and pro forma test period operating expenses of \$66,109 and \$58,706, respectively. The following are Staff's recommended adjustments to Lakewood's actual test period operations and discussions of Lakewood's proposed pro forma adjustments:

Owner/Manager Fee: Lakewood reported a test period owner/manager fee expense of \$6,600. Upon its review of the accountant's workpapers, Staff determined that the test period owner/manager fee represented a misclassification of Lakewood's routine maintenance fee.

In the test period, Lakewood paid F&W Operations a routine maintenance fee of \$550 per month. Because Lakewood and F&W Operations have common ownership, the routine maintenance contract is a less-than-arms-length transaction. Transactions that are less-than-arms-length are more closely scrutinized to insure that they do not result in unreasonable costs being passed on to the ratepayers. To prove that the routine maintenance fee paid to F&W Operations is reasonable, Lakewood provided Staff with a written estimate from the River City Sewer Service.

Staff compared the written estimate with the F&W Operations contract and concluded that the test period routine maintenance fee is reasonable. Furthermore, the Commission allows sewer utilities of Lakewood's size an owner/manager fee of \$2,400, which should be allowed in this instance.

Staff recommends that Lakewood's test period operations be increased by \$2,400 to reflect the inclusion of the owner/manager fee of \$2,400 and routine maintenance fee of \$6,600.

Utilities: Lakewood reported a test period utility expense of \$6,031. A detailed analysis of the test period invoices revealed that the actual utility expense was \$5,866, a difference of \$165 from the amount Lakewood reported. Accordingly, utility expense has been decreased by \$165.

Maintenance and Supplies: Lakewood reported test period maintenance and supplies expense of \$18,964,¹ which includes a \$750 service deposit paid to Kentucky Utilities ("KU"). Since deposits are ultimately returned to the depositor, Lakewood should have reported the KU deposit as an asset on the balance sheet and not as an operating expense. Therefore, maintenance and supplies expense has been reduced by \$750.

Staff reviewed the test period invoices and determined that the following expenditures are capital in nature:

Flow Meter & Installation	\$ 5,331
Chlorinator Tube & Installation	\$ 224
Replaced Diffusers	\$ 550
Replaced Bar Screen	\$ 450

Upon consulting with the Commission's Engineering Division ("Engineering"), Staff concluded that the chlorinator tube and diffusers should be depreciated over 3 years, the flow meter should be depreciated over 5 years, and the bar screen depreciated over 10 years. Therefore, maintenance and supplies expense has been decreased by \$6,555 and depreciation expense increased by \$1,369.²

¹	Maintenance	\$ 10,773
	Treatment & Disposal Supplies	+ 8,191
	Maintenance & Supplies	<u>\$ 18,964</u>

²	Flow Meter	\$ 5,331	+	5 Years	=	\$ 1,066
	Chlorinator Tube	224	+	3 Years	=	75
	Diffusers	550	+	3 Years	=	183
	Bar Screen	+ 450	+	10 Years	=	+ 45
	Totals	<u>\$ 6,555</u>				<u>\$ 1,369</u>

Upon further review of the test period invoices, Staff determined that the following expenditures were non-recurring in nature:

Lagoon Dye Test	\$ 925
Rebuilt Aerator	\$ 900
Paint & Scrape Tanks & Wells	\$ 4,177

Upon consulting with Engineering, Staff concluded that the lagoon dye test should be amortized over 3 years and the remaining expenditures amortized over 5 years. Thus, maintenance and supplies expense has been decreased by \$6,002 and amortization expense increased by \$1,323.³

Agency Collection Fee: Lakewood reported test period agency collection fee expense of \$5,412. Lakewood's customer billing and collection is performed by the Oldham County Water District at a fee of \$2 per customer. Based on this fee and the number of test period customers, Lakewood's pro forma agency collection fee expense would be \$5,328.⁴ Accordingly, agency collection fee expense has been decreased by \$84.

Accounting Fee: Upon review of the invoices, Staff noted that in 1993 Lakewood paid its accountant \$650 to prepare the 1992 financial statements and income tax returns. Staff is of the

³	Lagoon Dye Test	\$ 925	+	3 Years	=	\$ 308
	Aerator	900	+	5 Years	=	180
	Paint & Scrape Equip.	+ 4,177	+	5 Years	=	+ 835
	Totals	<u>\$ 6,002</u>				<u>\$ 1,323</u>

⁴ 2,664 No. of Customers x \$2 Billing Rate = \$ 5,328.

opinion that the accounting fees are reasonable and should be reflected in Lakewood's test period operations. Thus, test period operating expenses have been increased by \$650.

Rate Case Cost: Lakewood proposed to increase its operating expenses by \$1,800 to reflect the cost of preparing this rate case. At the field review, Lakewood provided an invoice from its accountant showing that the actual rate case cost incurred is \$1,339.

Staff has reviewed the accountant's invoice and is of the opinion that it is reasonable. Since utilities normally do not request a rate increase every year, rate case cost has typically been amortized over a 3-year period. Staff has calculated amortization expense of \$446 based on amortizing this cost over a 3-year period, and recommends that test period operations be increased by that amount.

Depreciation: Lakewood proposed a pro forma level of depreciation expense of \$3,655, a decrease of \$9,160 from the amount it reported. To document its pro forma depreciation expense, Lakewood attached a copy of its 1993 depreciation schedule to the application.

In 1990, Lakewood Valley Development Sewer System was transferred to its current owner.⁵ The Commission directed Lakewood to file the journal entries to reflect the transfer and required the entries to be in accordance with the prescribed Uniform System of Accounts ("USoA") for sewer utilities.

The USoA for Class C and D sewer utilities required Lakewood to use the following guidelines when it recorded its journal entries: (1) the original cost of plant, estimated if not known, to be debited to the appropriate utility plant in service accounts; (2) the applicable accumulated depreciation and amortization is to be credited to the appropriate accumulated depreciation or amortization account; (3) the applicable contribution in aid of construction ("CIAC") is to be credited to account 271, CIAC; and (4) any amount remaining is to be closed to account 108, Utility Plant Acquisition Adjustments.⁶

Given the above USoA requirements, Staff is of the opinion that Lakewood erred in recording its general journal entries and therefore its pro forma depreciation expense is incorrect. Based

⁵ Case No. 90-198, Lakewood Valley Development Company Sewer System, a Kentucky General Partnership, Application for Approval of the Transfer of Lakewood Valley Development Company Sewer System Treatment Plant to Lakewood Valley Sewer, Co., Inc., Order issued August 13, 1990.

⁶ USoA for Class C and D Sewer Utilities, pages 19 and 20.

on the 1989 Annual Report and the information in Case No. 90-198, Lakewood's general journal entry would be as follows:

Utility Plant In Service	\$ 105,715	
Utility Plant Acquisition Adjustment	\$ 6,445	
Accumulated Depreciation		\$ 82,160
Cash		\$ 30,000

Upon consulting with Engineering, Staff concluded that Lakewood's utility plant should be depreciated over 20 years, which would result in depreciation expense of \$5,286.⁷ Therefore, Staff recommends that Lakewood's proposed adjustment be denied and depreciation expense decreased by \$7,529.

Interest: Lakewood reported test period interest expense of \$3,387. Interest expense consisted of payments to Lakewood Development and F&W Operations of \$2,691 and \$696, respectively.

On August 22, 1990, Frank Wethington, Lakewood's current owner, purchased Lakewood Valley Development Company Sewer System with a \$30,000 promissory note from Lakewood Development. The promissory note has a 10 year term and an interest rate of 10 percent per annum.

According to KRS 278.300(1), "[n]o utility shall issue any securities or evidences of indebtedness, or assume any obligation or liability in respect to the securities or evidences of indebtedness of any other person until it has been authorized so to do by order of the commission." Upon review of Case No. 90-198,

⁷ \$105,715 ÷ 20 Years = \$5,286.

Staff determined that Lakewood did not request or receive Commission authorization to incur its indebtedness to Lakewood Development.

Given that the Lakewood Development indebtedness was not authorized by the Commission, Staff is of the opinion and recommends that the associated interest expense be borne by Lakewood's owner and not its ratepayers. Accordingly, interest expense has been decreased by \$2,690.

At the end of the test period, Lakewood reported a balance of \$25,768 in its accounts payable to associated companies. According to Lakewood, the account payable arose from its inability to pay F&W Operations for test period maintenance. Staff is of the opinion and recommends that the interest on debt incurred to finance current operations should be disallowed. Accordingly the remaining interest expense of \$696 has been eliminated from Lakewood's test period operations.

Operations Summary

Based on the recommendations of Staff contained in this report, Lakewood's operating statement would appear as set forth in Appendix B to this report.

C. Revenue Requirements Determination

The approach frequently used by this Commission to determine revenue requirements for small, privately-owned utilities is the operating ratio. This Approach is used primarily when there is no

basis for rate-of-return determination or the cost of the utility has fully or largely been recovered through the receipt of contributions. Staff recommends the use of this approach in determining Lakewood's revenue requirement.

Staff's adjusted operations provide Lakewood with an operating ratio of 127.31 percent.⁸ Combined with Lakewood's requested increase of \$29,872 the result is an operating ratio of 73.06 percent.⁹

Lakewood requested an operating ratio of 88 percent. Staff is of the opinion that this would allow Lakewood sufficient revenue to cover its operating expenses, and to provide for reasonable equity growth. An operating ratio of 88 percent results in a revenue requirement of \$58,195.¹⁰ Therefore, Staff recommends that Lakewood be allowed to increase its annual operating revenues by \$17,969.¹¹

⁸ \$51,212 + \$40,226 = 127.31%.

⁹ \$51,212 + (\$40,226 + \$29,872) = 73.06%.

¹⁰

Adjusted Operating Expenses	\$ 51,212
Operating Ratio	+ 88%
Required Operating Revenue	<u>\$ 58,195</u>

¹¹

Required Operating Revenue	\$ 58,195
Normalized Operating Revenue	- 40,226
Required Revenue Increase	<u>\$ 17,969</u>

D. Surcharge

Lakewood informed Staff that F&W Operations was going to place rip rap around its lagoon at a cost of \$18,000. Lakewood provided the bid from F&W Operations and a bid from River City Sewer Service to show that the F&W Operations bid is reasonable.

Upon consulting with Engineering, Staff was informed that the rip rap will reduce soil erosion, eliminate muskrat damage, and cut down on the cost of maintenance on Lakewood's lagoon. Furthermore, Engineering and Staff determined that the rip rap is necessary and that the bid from F&W Operations should be accepted as a reasonable estimate of the cost Lakewood will incur to install the rip rap around its lagoon.

Because the rip rap is a nonrecurring expenditure, if Lakewood is allowed to include the rip rap cost in its revenue requirement determination, then the potential exists, once the rip rap is installed, for Lakewood to earn in excess of the 88 percent operating ratio recommended herein. In order to fund the rip rap installation and to negate the possibility of future over-earning, Lakewood should be granted a monthly surcharge. Staff is of the opinion and recommends that the surcharge be placed in effect for a 60-month period, or until \$18,000 has been collected. This would result in monthly surcharge collections of \$300.¹²

¹² \$18,000 ÷ 60-Months = \$300.

If the surcharge is granted, the proceeds should be placed in a separate interest-bearing account. Monthly transfers to the surcharge account should equal the monthly surcharge recommended herein and should be transferred from Lakewood's gross operating revenues prior to those revenues being dispersed for another purpose. Lakewood should file monthly activity reports that contain the following information: the monthly surcharge billings and collections; the monthly bank statement; and payments from the account. Lakewood's failure to comply with the above funding requirements or to file the monthly reports should warrant the revocation of the surcharge and the refunding of the monies already collected, plus interest thereon.

The Commission should periodically inspect Lakewood's treatment plant to insure that rip rap installation is being performed. Lakewood's failure to install the rip rap by August 31, 1994 should warrant the revocation of the surcharge and the refunding of the monies already collected plus interest.


The surcharge constitutes contributions, and should be accounted for in the manner prescribed by the Uniform System of Accounts for Class C Sewer Utilities. The monthly billing should be debited to customer accounts receivable and credited to the contributions account. When the amount is collected, special funds would be debited and customer accounts credited.

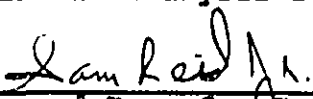
E. Rate Design

Surcharge Rate: Staff recommends implementing a monthly surcharge of \$1.35 over a period of 60 months to cover the costs associated with installing the rip rap around the lagoon.¹³ The surcharge as set out in Appendix A is adequate to cover these costs.

Monthly Rate: In its application, Lakewood filed a schedule of present and proposed rates that did not include any changes in rate design. Staff agrees that the current rate structure should not be altered. The recommended rates will generate \$58,208, satisfying the operating revenue from rates requirement. Therefore, staff recommends the rates in appendix A be approved.

F. Signatures


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Prepared By: Sam Reid
Public Utility Rate Analyst
Communications, Water and
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¹³	Cost to Install Rip Rap	\$ 18,000
	Amortization Period	+ 60-Months
	Monthly Amortization	\$ 300
	No. of Customers	+ 222
	Monthly Customer Surcharge	<u>\$ 1.35</u>

APPENDIX A
TO STAFF REPORT CASE NO. 93-263

The Staff recommends the following rate be prescribed for customers in the area served by Lakewood Valley Sewer Company, Inc.

<u>Customer Class</u>	<u>Rate Per Unit</u>
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Single Family Residential	\$21.85
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Monthly Surcharge

\$1.35 for a period of 60 months or until \$18,000 has been collected.

APPENDIX B
TO STAFF REPORT CASE NO. 93-279

	<u>Actual Operations</u>	<u>Pro Forma Adjustments</u>	<u>Pro Forma Operations</u>
Operating Revenue:			
Residential Flat Rate	<u>\$ 40,689</u>	<u>\$< 463 ></u>	<u>\$ 40,226</u>
Operating Expenses:			
Owner/Manager Fee	\$ 6,600	\$< 4,200 >	\$ 2,400
Secretarial Salary	1,200	-0-	1,200
Sludge Hauling	6,794	-0-	6,794
Utility Expense	6,031	< 165 >	5,866
Chemicals	4,599	-0-	4,599
Lab Fees	2,521	-0-	2,521
Routine Maintenance	-0-	6,600	6,600
Maintenance & Supplies	18,964	< 13,307 >	5,657
Agency Collection Fee	5,412	< 84 >	5,328
Bank Charges	43	-0-	43
Accounting Fee	-0-	650	650
Miscellaneous	614	-0-	614
Depreciation Expense	12,815	< 6,160 >	6,655
Amortization Expense	-0-	1,769	1,769
Taxes Other Than Income	<u>516</u>	<u>-0-</u>	<u>516</u>
Total Operating Expenses	<u>\$ 66,109</u>	<u>\$< 14,897 ></u>	<u>\$ 51,212</u>
Net Operating Income	<u>\$< 25,420 ></u>	<u>\$ 14,434</u>	<u>\$< 10,986 ></u>
Other Deductions:			
Interest Expense	<u>3,387</u>	<u>< 3,387 ></u>	<u>-0-</u>
Net Income	<u>\$< 28,807 ></u>	<u>\$ 17,821</u>	<u>\$< 10,986 ></u>